Wealth Management
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Stu's View

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Curbing your enthusiasm in a bull market

As I have sat back over the last few weeks and watched the high-stakes/high-return action dominating the financial news, I felt compelled to offer up some thoughts on the other side of the investment equation – i.e. risk. The first investing principle is "without risk there can be no expected return." Yet the narrative in certain parts of the market today does not seem to pay much attention to risk management. Investing is being called a "game" or "too easy" by some of the more recently appointed experts and social media celebrities While investing can be fun, and made easier by following a systematic investment process, it's by no means a trip to the casino.

Managing market FOMO (fear of missing out)

We are all susceptible to taking excessive risk if we do not follow a disciplined investment process. There is nothing more difficult than trying to control feelings of envy when we hear a family member, a friend, a colleague or a celebrity boasting of "massive returns" in their portfolio. These feelings may cause us to look at our portfolio and wonder why similar returns were not produced. What is often missing in the case of boasting of "massive returns" is the level of risk taken to achieve said returns. How much of your total wealth do you want to subject to one single investment? How would you react to seeing your portfolio decline 25% or 30% in a day or a week? Would that be cause for concern? Do you need to generate "massive returns" to achieve your goals and objectives in the first place?

We always need to do our best to manage our emotions when it comes to investing. Emotions can lead us astray in almost all cases, and nobody is perfect at managing their emotions. But following our "gut instincts" usually isn't a great investment strategy either. Famous investor Benjamin Graham once said "Investing isn't about beating others at their game. It's about controlling yourself at your own game." This is very true in any environment, but especially today in an era of never-ending narratives driven by social media. There are ways to lessen

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the impact of our emotions on our investment decisions, which I will touch on in this note. I also explain why risk management needs to be front and center at all times in the investment process.

Overly optimistic

Small parts of financial markets are getting big attention, which appears to be excessively optimistic.

- Cryptoassets, including bitcoin, ethereum, dogecoin and many others, have clocked in impressive rallies over the last year, with more recent gains driven by celebrity endorsement and social media hype. While the long-term future of these cryptoassets should not be dismissed, investors need to be aware of the level of risk associated with investing in these assets today. Stories of rags-to-riches investors making it big in crypto abound, as do the celebrity endorsements. Historically, these are markers of excessive optimism.

- Special Purpose Acquisition Companies (aka SPACs) are essentially "blank cheque" companies – shell companies that use the cash raised in their initial public offerings (IPOs) to buy a privately held company and take it public, usually within a two-year window. They dominated the IPO scene in 2020, having raised $82 billion in 2020, a more than six-fold increase from the year before and a figure greater than all of the money previously raised. So far in 2021, we are set to see another record year for SPACs. SPACs provide private companies a lower-cost and faster path to the public markets that endures less scrutiny than a traditional IPO, since they are going public via an acquisition or merger instead of an independent IPO. These are certainly not low-risk investments as some people have made them out to be. Investors in SPACs need to be aware of shareholder structures before and after mergers. The dilution of equity warrants usually are more favourable to earlier investors, and the track record for SPACs since 2015 is not very impressive at all. According to the Wall Street Journal, as of November 2020, of 107 that have gone public since 2015 and executed deals, the average return on their common stock has been a loss of 1.4%.

- We have also seen strong price appreciation for some smaller-sized, and currently unprofitable companies within the technology and communication services, information technology and consumer sectors. The strong gains in the stocks of these companies despite any fundamental earnings or profits, or cash flows, is a cause for some concern.

- Individual investors have been piling into the market since the COVID crisis began last year. This has been driven by zero-commission trading in most U.S. online brokerage accounts, the quarantine/lockdown effect, reduced sports gambling due to the lockdowns and the help of stimulus checks. At the same time, leveraged or margin investing among retail investors has also approached new all-time highs, which may be seen as another sign of excessive optimism in parts of the market today. While margin can be used with good reason in an investment strategy, the use of margin not only amplifies returns but can also amplify the risks as well.

Be wary of story time

I used to love story time in grade school. I would get excited to listen to the teacher tell a tale of a fictional or non-fictional character triumph over adversity, or save the day and end on the classic line "... and they all lived happily ever after." Nowhere is the power of the story more prevalent than with new investments, such as cryptoassets, IPOs or SPACs. Narratives such as "it is different this time" or "this is a paradigm shift" or "this is the new normal" usually draw up feelings of excitement and euphoria. These narratives can also build in an idea of scarcity and limited time offerings which can further the fear of missing out.

Such stories usually bypass the brain and go straight for the heart, according to behavioural economist Dr. Daniel Crosby in his 2016 book titled The Laws of Wealth. There are usually no good investment decisions that are born out of emotions like excitement and fear of missing out. The merits of each individual investment needs to be assessed along with its impact on other investments in the portfolio as part of a proper investment process. Resist the urge to subject your wealth plan to undue risk.

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Coping with feelings of envy

To manage feelings of envy – such as "my portfolio is only up 15% year to date, but the market is up 20%" – try instead to benchmark the portfolio performance to your personal needs. This is the objective behind goals-based investing, which is something I have referenced in past notes. Compared to a traditional investing approach where an investor will compare their portfolio returns to an index, like the S&P/TSX Composite, the goals-based investor instead compares their returns to the pre-determined required return to achieve their goals or objectives. What matters is the focus on the individual's needs, not generating superior returns, especially in the short term. Goals-based investing allocates assets to meet these financial objectives and address the liabilities over multiple time horizons. A required return to meet these objectives is determined and continuously monitored relative to one's tolerance and capacity for risk. In this context, risk is easily discussed without complex mathematics. Risk simply materializes when assets are insufficient to meet the goals, resulting in a shortfall to the goal. In this context, taking on more investment risk to achieve goals/objectives is one approach, as is extending the time horizon and/or increasing capital contributions. Either way, goals-based investing can help you avoid taking on unnecessary risks.

Another approach to managing feelings of envy is to try your best to ignore what others are doing. The old saying "if all of your friends jumped off a bridge, doesn't mean you should too" certainly comes to mind. With your own goals and objectives in mind that correspond to your required rate of return, you do not necessarily have to worry about the latest and greatest story, or narrative. You can sit back and take comfort knowing that as long as your portfolio is generating the required rate of return over time, you are going to meet your goal. You can objectively define risk

relative to return that make sense to your unique circumstances and not necessarily have to worry about why an index moves up and down.

The objective here of managing the feelings of envy, fear of missing out, regret, etc. are all about making sure these behavioural biases that we all have do not get in the way of the magic of compounding of returns in your portfolio. Remember, compounding of returns – which is the foundation for wealth creation and capital preservation – takes time. It likely should be boring and unexciting. This is a marathon and not a sprint.

Behaving ourselves when others are greedy

We should be long-term optimists in the investment world, but it's healthy to be skeptical in the short term as well. I've mentioned a few parts of the financial market today that appear to be exhibiting signs of excessive optimism. Here are some important reminders for those who may be considering taking on additional risk in their portfolios today:

- Be sure to reflect on your past investment decisions. When you have a new investment idea, think about how this idea came to you. Have past decisions originating from this source resulted in a positive outcome? Why or why not? What was the role of luck vs. skill in past decisions? Asking such questions can help you decipher the amount of risk you should be willing to take in this new investment idea.
- Challenge your own investment thesis. Ask yourself questions like, "How can I be wrong?" What does the downside look like and how will I react? What is the expected return of this investment and how does this impact the rest of my portfolio and my required rate of return?
- Be sure to not make any decision under pressure, or out of excitement. Slow down and take the time to understand the above considerations before making a final decision. Research has shown that investment decisions made under duress or euphoria results in poor investment outcomes relative to decisions made with little to no emotion.
- Consider implementing a systematic rebalancing process in the portfolio. This can help take the emotions out of the decision-making process as the market ebbs and flows.

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- Make sure you take advantage of the only free lunch in investing – diversification. Varying degrees of correlation amongst portfolio holdings are a benefit as the market ebbs and flows by keeping your portfolio on a steadier path forward.
- Keep a small investment account (e.g. less than 5% of your total wealth) that is separate from your long-term investments if you really want to try your luck. This can allow for experimentation and trying out some of your investment ideas. Keep an investment journal that tracks all of your decisions (and non-decisions) in this account. Revisit your journal entries every so often to see how you have done.

Final thoughts

Market volatility and risk are ever-present in financial markets. There is always something else that will be worrying investors even if we can't see what that might be today. As I've written in past notes, it is important to focus on the signals and not the noise. Goals-based investing is the key to making it through over the long term, and not exposing your portfolio to undue risks caused by feelings of envy or regret. The only prediction that I will ever make with 100% probability of occurrence is that another correction/bear market will be coming at some point. The timing and magnitude are uncertain, but make no mistake about it, it's coming. It certainly seems like parts of the market today are showing signs of excessive optimism. With financial markets being mean-reverting mechanisms, caution should be taken in those parts of the market when the crowds appear to be overly optimistic or greedy.

This is certainly not a doomsday prediction by any stretch of the imagination. Doomsayers will always be out there and they are usually most vocal during correction periods, and likewise during periods of market exuberance. Even a broken clock is correct twice a day. That's not the same as short-term pessimism and long-term optimism, which is the key to successful investing.

I would be remiss if I didn't say that there are plenty of reasons to be reasonably optimistic about the short term. The latest economic indicators (e.g. retail sales, industrial production, housing, employment) have all shown signs of improvement. With COVID cases on the decline now following lockdowns, and even more stimulus to come, this should be good news for spending and corporate profits. This short-term optimism may mean that small parts of the market that seem overly optimistic, might see further expansion in levels of optimism and even euphoria. And there are of course plenty of reasons to be optimistic in the long term too. For instance, advances in technology and health care to meet the challenges faced by our society present compelling long-term investment opportunities. Solutions to face an aging population, global climate change, renewing our infrastructure and serving the needs of a growing global middle class will be just a few of the long-term investment opportunities. I'll be sure to cover these in great detail in future notes.

Please reach out to your Investment Counsellor if you have any questions or concerns related to the content raised in this article.

Be well,
Stu

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S&P/TSX Composite Index: The S&P/TSX Composite Index is the benchmark Canadian index, representing roughly 70% of the total market capitalization on the Toronto Stock Exchange with about 250 companies included in it. The Toronto Stock Exchange is made up of over 1,500 companies. It replaces the earlier TSE 300 index.

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